



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PPD 730.5.45.1

November 3, 2008
08-PPD-037(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA
HEADS OF PRINCIPAL STAFF ELEMENTS

SUBJECT: Audit Guidance on Assessing Compensation Reasonableness through
Benchmarking

Auditors should ascertain the composition of the survey data the contractor uses to benchmark executive compensation for reasonableness. Unallowable elements should be identified and removed from the survey data prior to performing the benchmarking. Auditors may seek the assistance of a compensation regional technical specialist to assess market survey data.

Contractors may benchmark compensation for reasonableness using a survey that may contain unallowable costs. FAR 31.205-6(b)(2), *Compensation not covered by labor-management agreements*, states that only allowable elements should be included when determining reasonableness. Specifically, FAR 31.205-6(b)(2) states:

*Compensation for each employee or job class of employees must be reasonable for the work performed. Compensation is reasonable if the aggregate of each measurable and **allowable element** sums to a reasonable total. In determining the reasonableness of total compensation, **consider only allowable individual elements of compensation (emphasis added).***

For example, several compensation surveys combine base salary, year-end cash incentives, and long-term incentive compensation (LTIC). The LTIC component has a significant potential for including unallowable compensation elements because it may include stock options, phantom stock, or stock appreciation rights that derive their value based on changes in the market price of the stock, which are unallowable in accordance with FAR 31.205-6(i)(1). Some surveys do not report LTIC in enough detail to allow for the auditor to determine if a portion of the total LTIC is based on unallowable compensation elements. In these cases, an alternative survey source may be needed to evaluate the reasonableness of the total compensation.

Auditors should ensure unallowable elements are identified and removed from contractor survey data prior to benchmarking. A compensation regional technical specialist may assist auditors in evaluating compensation survey data to remove unallowable cost elements in determining compensation reasonableness. Regional offices have reliable external survey data available to assist auditors in their evaluations.

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If FAO personnel have any questions, they should contact regional personnel. Regional personnel with any questions should contact Policy Programs Division, at (703) 767-2270 or email at dcaa-ppd@dcaa.mil.

/Signed/
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